



TESTIMONY OF

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**New York, NY**

Before the  
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Washington, D.C.

**TABLE OF CONTENTS**

TABLE OF CONTENTS.....	i
TABLE OF FIGURES.....	ii
QUALIFICATIONS .....	3
INTRODUCTION AND SUMMARY .....	4
I. THE CURRENT STATE OF THE MUSIC INDUSTRY .....	5
A. A Declining Market Drives a Higher Proportional Cost Base for Record Companies ...	5
B. The Current Economic Model for Record Companies Leaves No Room for Further Erosion of Margins .....	9
C. Retail Pressures Are Driving Lower Margins with Little or No Sharing of the Burden By Music Publishers .....	13
1. The Decline of Music Specialists and Rise of Big Box Retailers.....	13
2. Exclusive Content and Higher Discounts .....	14
3. Retailer Reductions in Inventory .....	17
D. The Digital Transition Requires Very Significant Infrastructure Investment in the Face of Declining Revenues.....	18
II. THE CURRENT MECHANICAL ROYALTY RATE AND STRUCTURE ARE OUTDATED AND UNWORKABLE IN THE CURRENT ENVIRONMENT .....	24
A. Record Companies Bear More Risk than Music Publishers.....	24
B. Music Publishers Bear Little or No Cost to Support a Product Through Its Entire Life Cycle .....	27
C. Participation on a Per Track Basis Does Not Match the Economic Reality of the Current Marketplace .....	30
CONCLUSION.....	32
APPENDIX 1.....	35

**TABLE OF FIGURES**

	<u>Page</u>
Figure 1: SoundScan Unit Sales.....	6
Figure 2: SoundScan Album Sales Decline .....	7
Figure 3: SoundScan Top 10 Albums .....	8
Figure 4: EMI Profit Margin .....	9
Figure 5: EMI Profit/Loss Excluding Foreign Licensing.....	10
Figure 6: EMI P&L Data.....	12
Figure 7: EMI Average Wholesale Discounts.....	15
Figure 8: Impact of Discounts on Copyright.....	16
Figure 9: EMI Global Supply Chain Systems .....	19
Figure 10: EMI Global Digital Investments.....	20
Figure 11: Economic Model.....	23
Figure 12: Publisher Rate of Return Constant Despite Risk.....	26
Figure 13: Life Cycle Economic Model.....	29
Figure 14: Participation is Not Aligned .....	32

**QUALIFICATIONS**

My name is Colin Finkelstein, and for the past four years I have been the Chief Financial Officer of EMI Music North America ("EMI Music NA"). In addition, I spent over nine years at EMI Music worldwide ("EMI Music") in various financial positions including Vice President, Finance for EMI Music. I have spent more than 18 years working in numerous facets of the music and entertainment business, and my career has spanned a number of entertainment platforms, including music, film, television, books and media. That experience has given me a broad perspective on the changing economics of the recording industry and allows me to compare and contrast our financial situation and business model in the current market with that of the music publishers. Based on my extensive experience in the music business, I am testifying to demonstrate the importance of the outcome of this proceeding to the recording industry as a whole and how the Copyright Royalty Judges' decision will impact EMI Music NA.

Prior to joining EMI Music NA as the CFO, I was the Chief Operating Officer and Chief Financial Officer of Classic Media, which is an independent film and music production/distribution company specializing in family programming. I remain on Classic Media's board of directors. Prior to joining Classic Media, I was the Chief Financial Officer of Golden Books Family Entertainment Inc. Golden Books' business was comprised of the Consumer Product segment, whose principal activities included publishing, production, licensing and marketing a wide range of children's books and family related entertainment products, and the Entertainment segment, whose primary activities comprised ownership of copyrights, distribution rights, trademarks or licenses relating to characters, television programs and motion pictures.

I am originally from South Africa, where I spent several years in Public Accounting with a large South Africa-based company. I began my career as an entrepreneur and owned several businesses, primarily in consulting, retail and entertainment.

### **INTRODUCTION AND SUMMARY**

The challenges facing the recording industry are truly unprecedented. Over the past five years, there has been an undeniable decline in the legal market for music products. This declining market has driven a higher proportional cost base for record companies and left most record companies only marginally profitable (if at all) on a domestic basis. Retail pressures have restrained prices and even forced price decreases, which has in turn increased margin pressure on EMI Music. Music publishers do not share this burden, as they are insulated from these market forces by the fixed “penny rate” mechanical license. In the current environment, EMI Music has consistently cut costs as a means of maintaining profitability. On a domestic sales basis, in most years EMI Music NA operates at a loss, and it has only been profitable by virtue of the foreign license income earned from North America-owned repertoire or from a massive hit on a domestic release. Although EMI Music like most record companies, has seen an increase in sales revenues from digital sales, those gains have so far been out-paced by the losses in physical sales. Whether digital sales lower our costs remains to be seen, but it is certain that we will see no cost reduction in the next five year period as EMI Music companies in North America and throughout the world make very significant infrastructure investments while needing to support duplicate supply chains for physical and digital products in the near term.

As EMI Music NA continues to respond to these conditions affecting the current marketplace, the mechanical royalty rate that is being set in this proceeding will have enormous impact on our ability to adapt to evolving business models and new technologies. The current

“penny rate” mechanical royalty is outdated and unworkable in the current environment and impedes EMI Music NA’s ability to effectively respond to market forces and earn a fair income from our sound recordings.

In my testimony, I will provide an overview of the current financial status of the recording industry in general and EMI Music in particular. I will discuss current market conditions and how the penny rate mechanical royalty structure insulates music publishers from these forces and discourages innovation and expansion in the market. I will discuss how the current rate structure forces record companies to bear a disproportionate amount of risk for their relative rate of return and how participation on a per track basis does not match the economic reality of the marketplace. I will conclude by describing adverse consequences of the current mechanical rate to EMI Music NA and the need for a percentage royalty rate in order to more fairly distribute the risk borne by the record companies so that the publishers share in that risk.

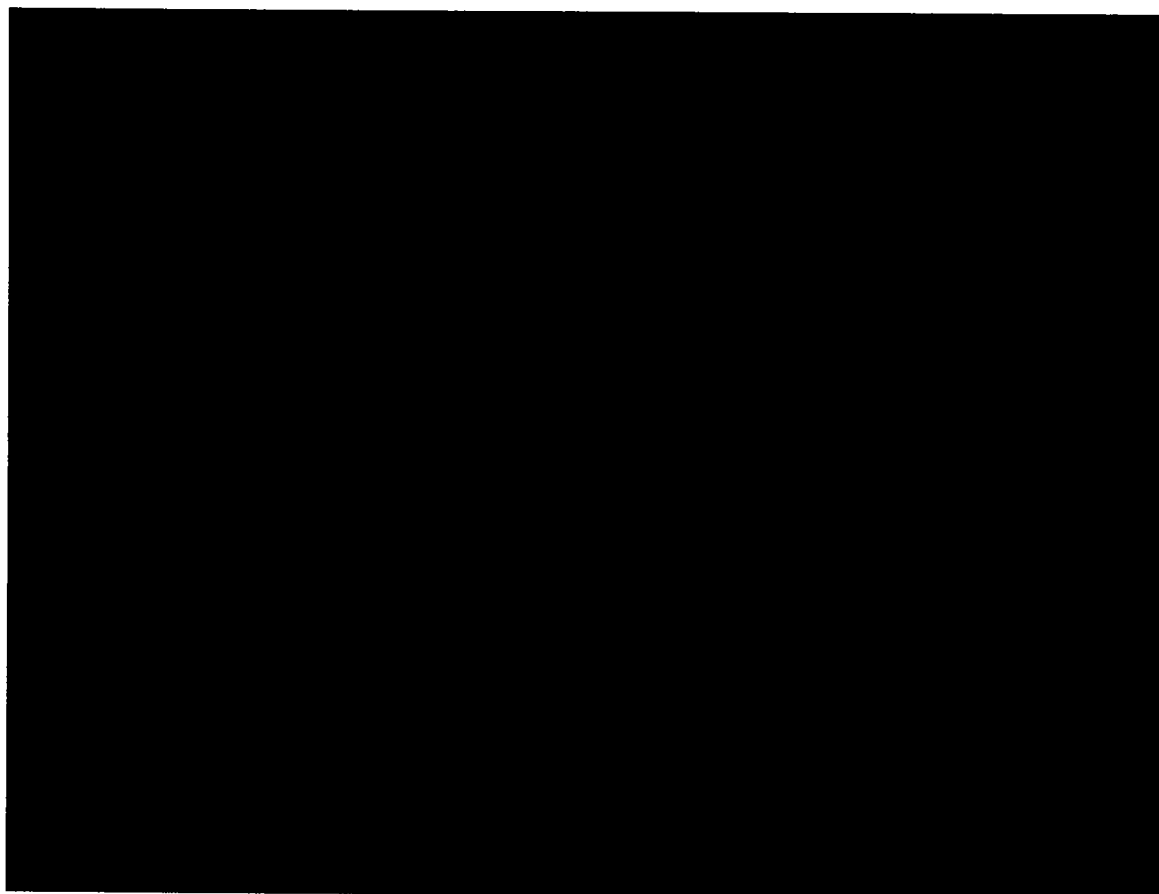
## **I. THE CURRENT STATE OF THE MUSIC INDUSTRY**

There are numerous factors at play in the current market. Declining sales have disproportionately increased the cost base for record companies. The current decline has left EMI Music NA only marginally profitable while leaving music publishers with healthy margins. Retail pressure is enormous with less higher margin catalog available in the market and effective price restraints and continual pressure to reduce prices. Although digital sales have increased in recent years, these increases are insufficient to make up for the decline in EMI Music NA’s physical sales and require significant investment in a new digital infrastructure.

### **A. A Declining Market Drives a Higher Proportional Cost Base for Record Companies**

Using any metric, the overall market for music products has declined and continues to decline. For example, Figure 1 shows SoundScan’s data on the number of units sold from 2000

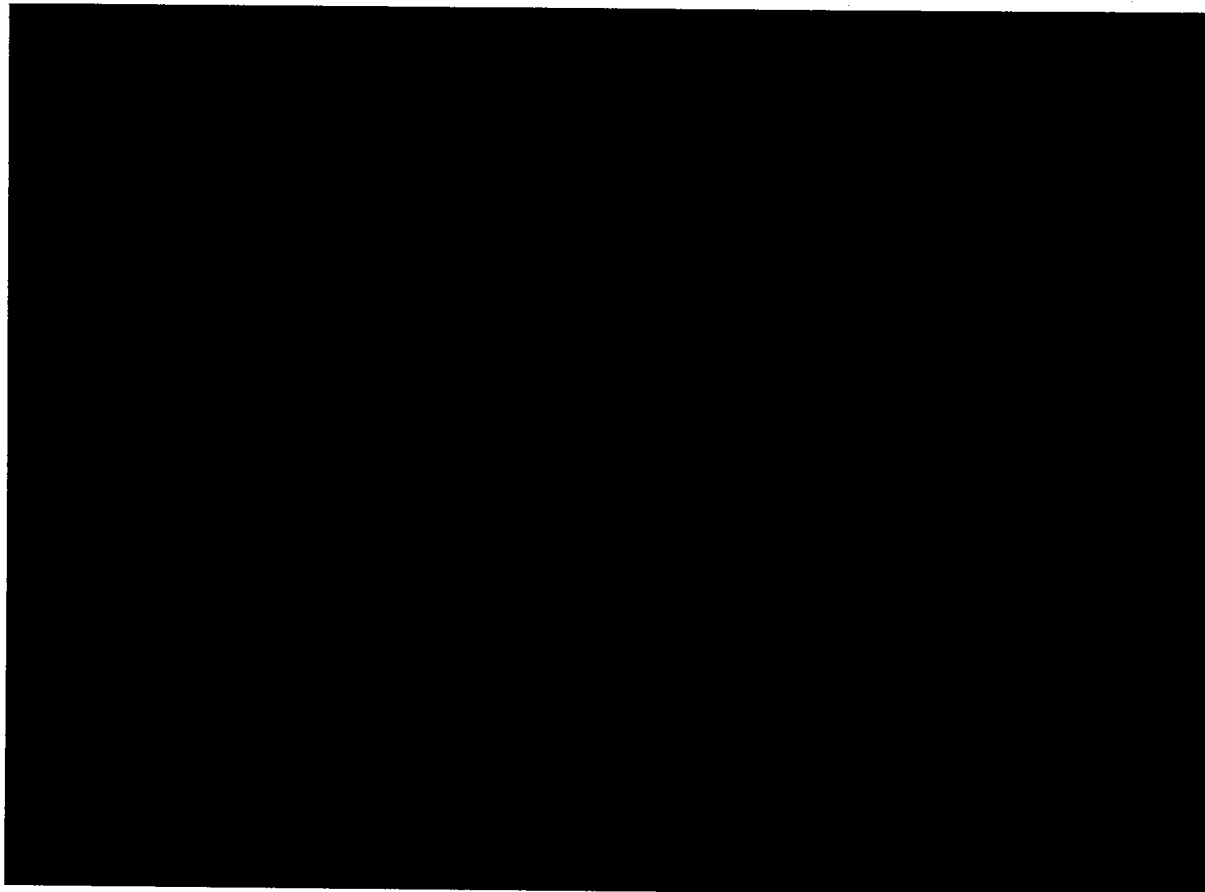
through 2005. In 2000, the industry sold approximately [REDACTED], while by 2005, overall physical sales had declined to [REDACTED]. Although digital sales have helped slow the rate of decline, the digital increases have not made up for the physical losses. In 2005, digital sales increased by just under [REDACTED] units compared to 2004 sales. Physical sales from 2004 to 2005, however, [REDACTED].



**Figure 1**

This decline is most apparent when looking at top ten album sales. As Figure 2 shows, total sales of top ten albums per year have been almost cut in half since 2000. While the top ten selling albums accounted for [REDACTED] of the total units sold in 2000, by 2005 the top ten accounted for only [REDACTED] of the total albums sold. This represents a [REDACTED] compound

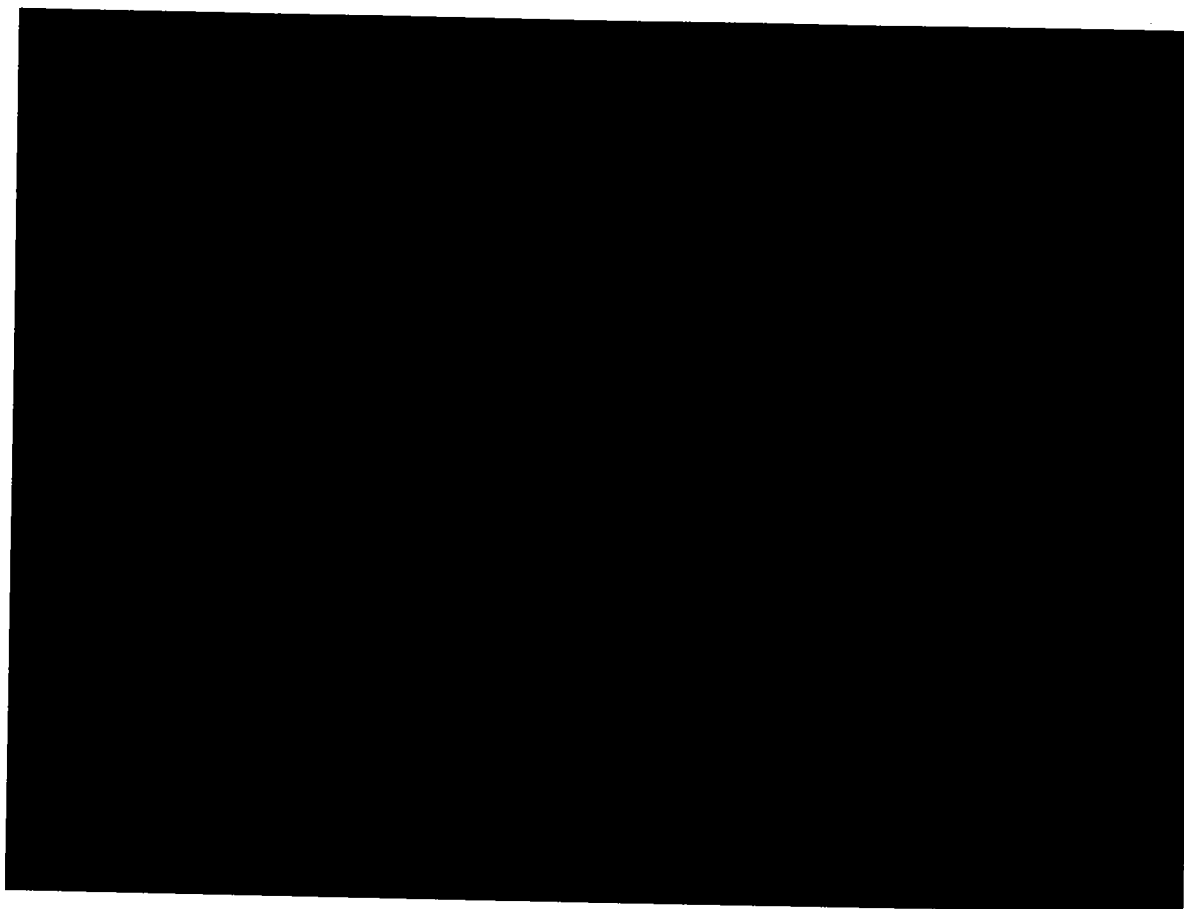
annual growth rate decline in top ten sales since 2000. The decline in top ten sellers is particularly important because record companies depend on hit records to be profitable.



**Figure 2**

Figure 3 provides the actual albums and units sold for 2000 and 2005. Eight of the top ten sellers from 2005 would not have even made the top ten in 2000. For example, 2005's top seller, Mariah Carey's *Emancipation of Mimi*, sold [REDACTED] units. Those sales in 2000, however, would have only earned Mariah Carey the eighth spot on that year's top ten. Similarly, the number 10 seller from 2000 was Destiny's Child's *The Writing's on The Wall* with [REDACTED] units sold. Those sales in 2005, however, would earn Destiny's Child the number three spot.





**Figure 3**

When evaluating EMI Music NA's net sales revenue, the picture is much the same. EMI Music NA's net sales revenue has declined [REDACTED], from [REDACTED] in 2000 to [REDACTED] in 2005. Again, EMI Music NA's digital sales in recent years have [REDACTED]. In general, this decline in net sales revenue is not only brought about by the decline in unit sales but also by considerable pricing pressure in the market.

With an overall declining market, EMI Music NA is under an incredible burden to maintain its current margins. The result is that every cost has to be effectively managed in order to maintain the same level of profitability particularly because EMI Music (like most record companies) has a relatively high fixed-cost base.

**B. The Current Economic Model for Record Companies Leaves No Room for Further Erosion of Margins**

In the face of this declining market, EMI Music NA's business model cannot sustain further erosion of profit margins by maintaining (much less increasing) the current mechanical royalty rate. Overall profitability for EMI Music NA [REDACTED].

Figure 4 shows EMI Music NA's profitability from 1999 to 2005, which includes all forms of income, including foreign and domestic licensing. As the chart demonstrates, EMI Music NA has been [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED].



**Figure 4**

Figure 5, however, shows EMI Music NA's profit and loss when foreign licensing income is excluded. Without foreign license income, EMI Music NA [REDACTED] [REDACTED]<sup>1</sup> EMI cannot, in short, sustain further erosion in domestic profit margins by paying more in U.S. mechanical royalties.



**Figure 5**

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<sup>1</sup> Foreign license income has been excluded for illustrative purposes. Foreign license income is, of course, revenue for EMI Music NA. However, for key analytic purposes, it is critical to distinguish between license income and revenue that is directly associated with the investment/risk cycle of the relevant sales market. Foreign license income is not a source of revenue for which EMI Music NA pays any mechanical royalties. Those royalties are paid to the publishers by the foreign licensee, in accordance with the rate set in the foreign territory. Foreign has been excluded in this analysis because it is ancillary and irrelevant to the U.S. market structure at issue since the license income is paid at the source. Profits would be even lower if domestic license income were also excluded.

In the face of what is a [REDACTED], EMI Music NA currently has no room for margin deterioration in the form of an increased mechanical royalty rate. After years of dealing with the fundamental changes in the business, EMI Music has already cut costs and found improvements in every cost component of the business.

For example, Figure 6 shows EMI Music NA's overall profit and loss data for the years 1999, 2004, and 2005. Although EMI Music NA's total profitability has [REDACTED] in 1999 to [REDACTED] in 2005, total revenue has actually [REDACTED] in 1999 to [REDACTED] in 2005. [REDACTED]. Manufacturing costs have been [REDACTED] in 1999 to [REDACTED] in 2005. Distribution costs have been [REDACTED] in 1999 to [REDACTED] in 2005. Marketing and promotion has been [REDACTED] in 1999 to [REDACTED] in 2005. During this same period, however, EMI Music NA has seen its mechanical royalty costs increase from [REDACTED] in 1999 to [REDACTED] in 2005.

Although EMI Music NA's overhead costs have [REDACTED] in 1999 to [REDACTED] in 2005, [REDACTED]. More importantly, however, [REDACTED] EMI Music NA's significant investment in IT infrastructure over the past three years and the additional overhead needed to address the changes in the marketplace.

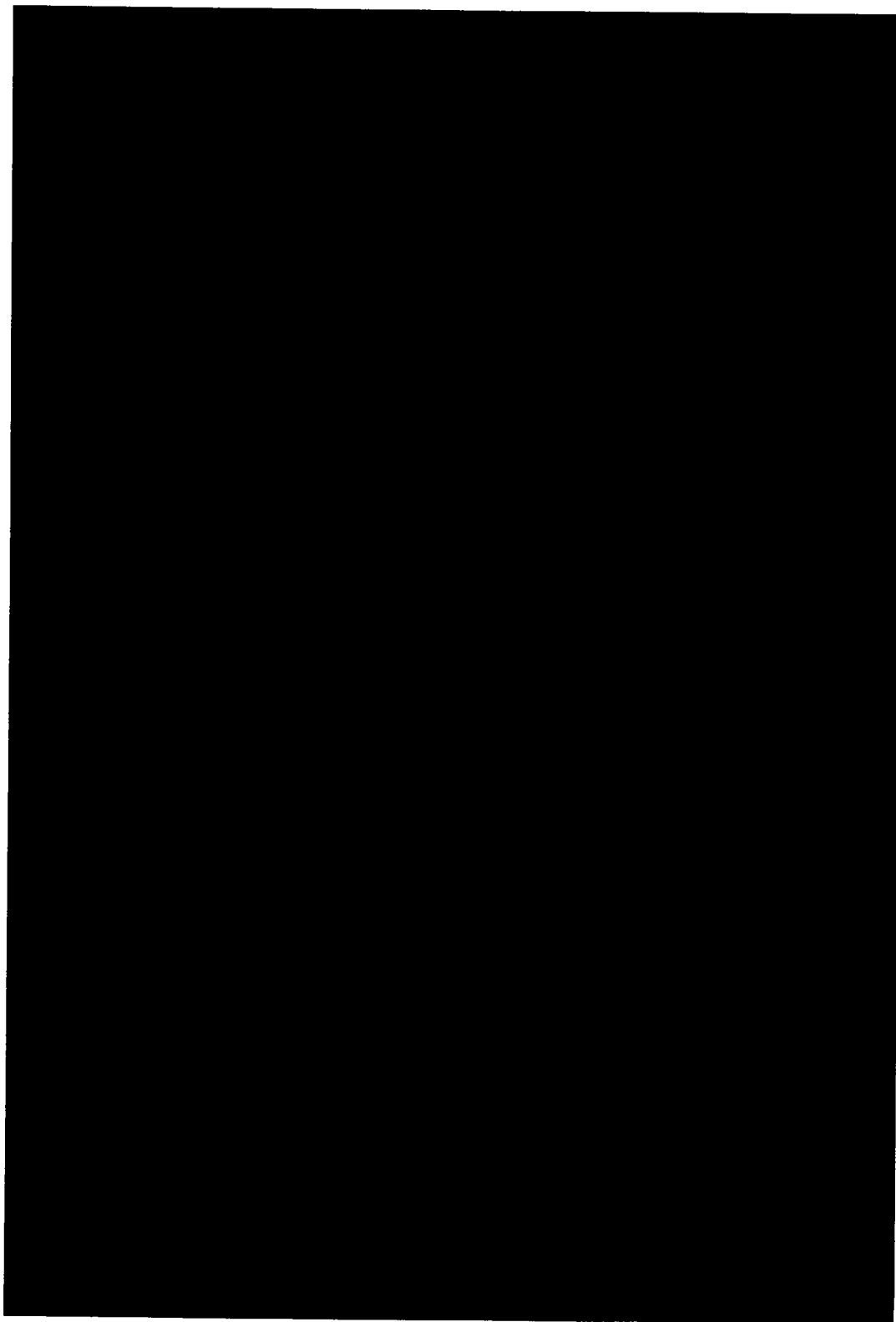


Figure 6



**C. Retail Pressures Are Driving Lower Margins with Little or No Sharing of the Burden By Music Publishers**

Retailers put record labels under tremendous pressure on physical product. Numerous forces are currently causing this retail pressure. As a result of the closure of specialty music stores and rise of big box retailers, there are fewer retailers in the marketplace. The recent bankruptcy of Tower Records, which is being liquidated, has only amplified the problem. For the retailers that remain, many are reducing their music inventory to make room for other products which further shrinks the shelf space available for catalog titles. As a result, the remaining retailers have considerably more leverage over this shrinking marketplace and are demanding exclusive content, higher discounts, and more upfront investment by record labels, especially over the holiday season. Finally, despite this increasing cost of entry into the retail marketplace, music products are facing competition from other forms of media, such as video games and DVDs, which are absorbing a larger percentage of consumer spending than ever before.

**1. The Decline of Music Specialists and Rise of Big Box Retailers**

Specialty music retailers are either shutting down completely or consolidating. Tower Records recently filed for bankruptcy and is being liquidated, resulting in a loss of 84 stores. The Virgin Megastore has declined from 20 stores in 2004 to 13 stores today, and the Virgin Megastore in Boston was just closed on November 4th of this year. TransWorld recently purchased both Musicland and Wherehouse, leaving only one national specialty retailer left in the marketplace. Following these purchases, TransWorld closed 475 Musicland stores and 75 Wherehouse stores. The decline of music specialists has shepherded the rise and dominance of big box retailers such as WalMart, BestBuy and Target in the music retail marketplace. Mass merchants now account for [REDACTED] of all of EMI Music NA's retail sales, [REDACTED] in 2002.

Non-traditional retailers are also gaining ground, driven by Starbucks, Apple, and Amazon.

Apple, in particular, currently dominates the digital space. Over 80% of all MP3 players on the market are iPods and Apple's iTunes Store controls nearly [REDACTED] of all of EMI Music NA's digital download sales, representing [REDACTED] of EMI Music NA's total sales.

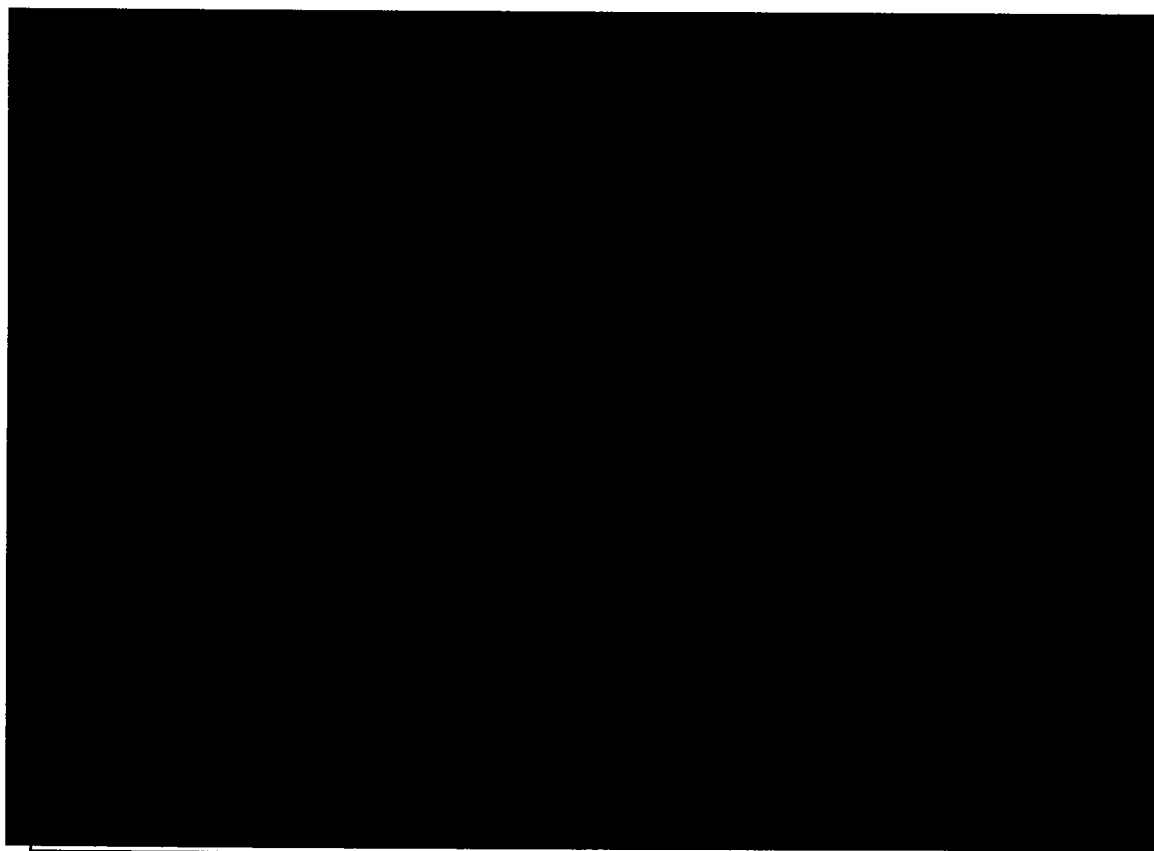
Due to the consolidation of the retail marketplace, EMI Music NA's top 10 current retail accounts now represent [REDACTED] of the total retail market. Independent retailers too are on the decline accounting for only [REDACTED] of EMI Music NA's current sales, compared to [REDACTED] in 2002. The practical effect of that consolidation is that the remaining retailers are in a position to exert greater leverage on pricing, inventory allocation, and to demand exclusive content.

## **2. Exclusive Content and Higher Discounts**

There is considerable pressure in the retail marketplace for quality content at a low price. In addition, a high priority for many retailers including Best Buy, WalMart, Target and Apple, is the sale of exclusive content. Exclusives entail tying extra content to a product to help drive traffic to retailers. So, for example, for a given album, we may produce a special acoustic version of a song for iTunes (which iTunes can then promote as an "iTunes original" bundled with the album), and we may produce a special CD product with extras songs and a video for BestBuy (which BestBuy market as a special version "only available at BestBuy"). These product exclusives, of course, are associated with increased manufacturing, distribution, and royalties costs but in general provide no additional revenue on a per album basis. Now, more often than not, retailers are demanding exclusive content and record companies are the ones bearing that cost.

In addition to demanding exclusive content, retailers have also significantly cut retail pricing. All of the major retailers now have new releases priced below \$10 an album. For

example, P. Diddy's new album, *Press Play* was just released on October 17 of this year, and could be purchased at most major retailers for \$10. Although it has only been out one month, it is currently available on Amazon for \$8.99. In some cases, decreased prices are the result of retailers loss-leading select music products (a practice which, in and of itself, further devalues the price of music). In other cases, these decreased prices are the continuation of a discounting trend that EMI Music NA has been experiencing for the past 15 years. As Figure 7 demonstrates, average EMI Music NA wholesale discounts [REDACTED] [REDACTED].

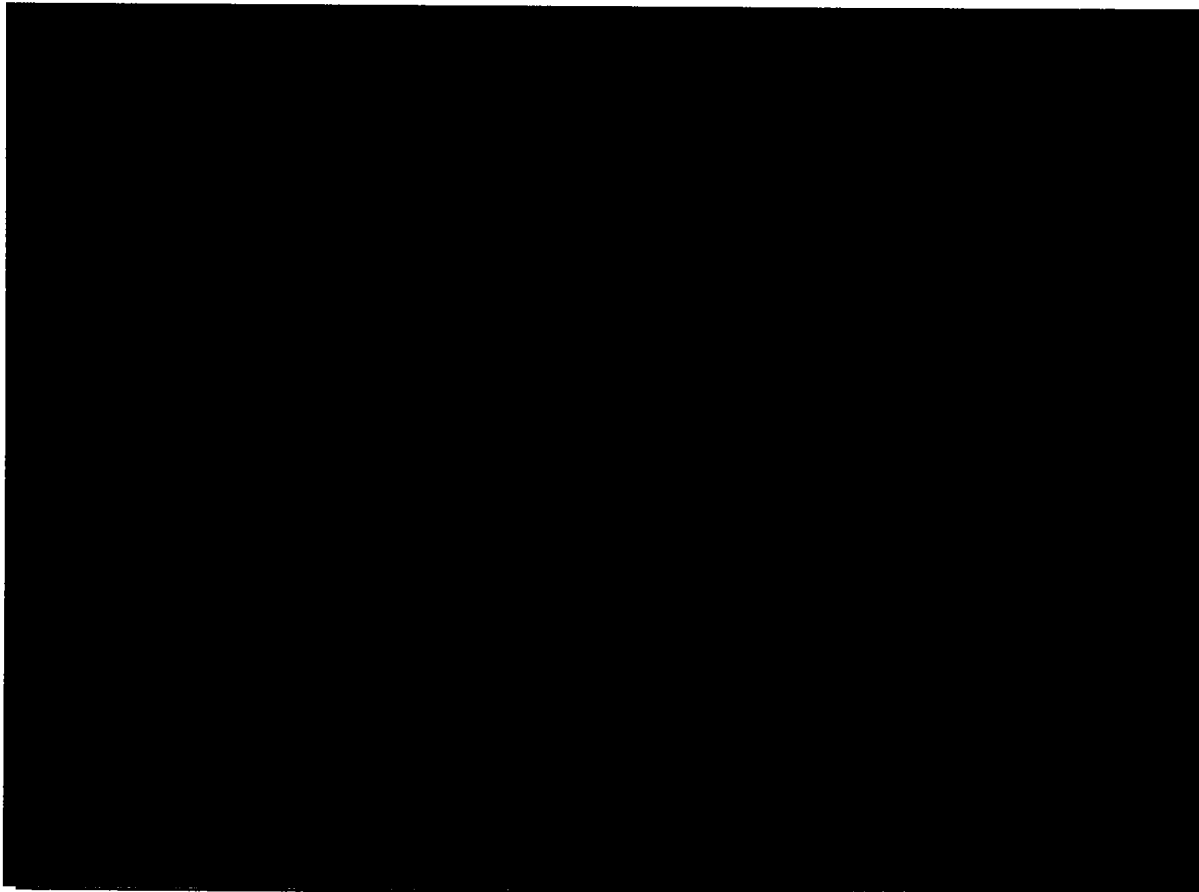


**Figure 7**

Of course, no fraction of the cost associated with discounting is ever absorbed by the music publishers, who are insulated from downward price pressures. As an illustrative example,



Figure 8 demonstrates that, at the current statutory rate, where a [REDACTED] discount is given on a wholesale price of [REDACTED], publishers are paid [REDACTED] of the discounted price. When the album is discounted by [REDACTED], however, the record company's margin decreases by [REDACTED], while the mechanical royalty payments made to the publishers *increase* to [REDACTED] of the discounted price. Thus, under the current penny per track royalty, the perverse result of discounting prices in response to market demands is that the publisher's share of wholesale revenues actually increases.



**Figure 8**

Of course, retail pricing pressure is resulting in similar discounting on top catalog DVDs.

During the holiday shopping season of 2005, popular movies such as Lord of the Rings, Harry Potter, and the Matrix franchise were priced as low as \$4.99 a DVD by some retailers. That

downward pricing, however, also impacts album prices because record companies are facing increasing competition from other forms of entertainment from games to DVDs.

### **3. Retailer Reductions in Inventory**

In addition to pricing pressures, retailers are reducing their overall music inventory. Most retailers have reduced their average music inventory to a two-to-four week supply for new releases and a four-to-six week supply on catalog. Record companies therefore have access to less retail space at a higher cost.

For example, Borders is drastically reducing its catalog inventory. In addition to focusing on better forecasting of new releases and making better use of inventory dollars for new releases and catalog, Borders has reduced average inventory across all stores based on sell through and in-stock rate metrics. Average Borders stores will now have only 12,000 stock keeping units ("SKUs") of music products, where they previously carried between 14,000 and 18,000 SKUs.

WalMart too is reducing its inventory. For example, WalMart has an initiative to reduce inventory store wide, and music is no exception. For 700 stores, however, WalMart is reducing the store space allocated to music retail by approximately two-to-four feet per location, and reallocating that space to mobile products and other phones and accessories. These reductions in store space will not necessarily impact top selling titles, but "deep" catalog (which has a higher margin for record companies) and the number of slower moving titles will be reduced.

The reductions by WalMart and Borders are just two examples of a renewed drive by retailers to run their music departments based on margin per square foot, rather than taking risks on new projects and developing artists. Indeed, these reductions in inventory present the biggest

risk in the earlier stages of a release or for developing artists, whose albums have yet to take hold in the marketplace.

These retail pressures are having a significant effect on EMI Music NA. Not only are record companies losing valuable shelf space on higher margin catalog titles, but in response to market pressures, EMI is increasing product discounts and creating more exclusive products, resulting in costs that are not equitably shared by music publishers. In fact, because the current mechanical royalty is calculated as a fixed cents per tune rate, the effective mechanical royalty paid to music publishers actually increases when record company net sales revenue declines.

**D. The Digital Transition Requires Very Significant Infrastructure Investment in the Face of Declining Revenues**

The growth of the digital marketplace brings unprecedented challenges to the music business. Although margins, in theory, can be higher because of reduced manufacturing and distribution costs, there are very large upfront investments that have to be made to support an ever evolving digital supply chain. When these investment costs are fully considered, EMI Music's digital business will not be profitable for the near future.

The cost of EMI Music's transition to a new digital business model is sizeable. As Figure 9 demonstrates, this transition requires either customization or total replacement of virtually every existing internal system. This transition requires large upfront investments in an entirely new supply chain that can create, process, manage and deliver audio, visual graphics, art, and metadata to consumers. For the near to long term, these investments must be made while simultaneously maintaining EMI Music's existing physical distribution supply systems - all in the face of declining physical sales. This transition requires a significant amount of duplication of staff to support both physical and digital sales, marketing and supply chains.

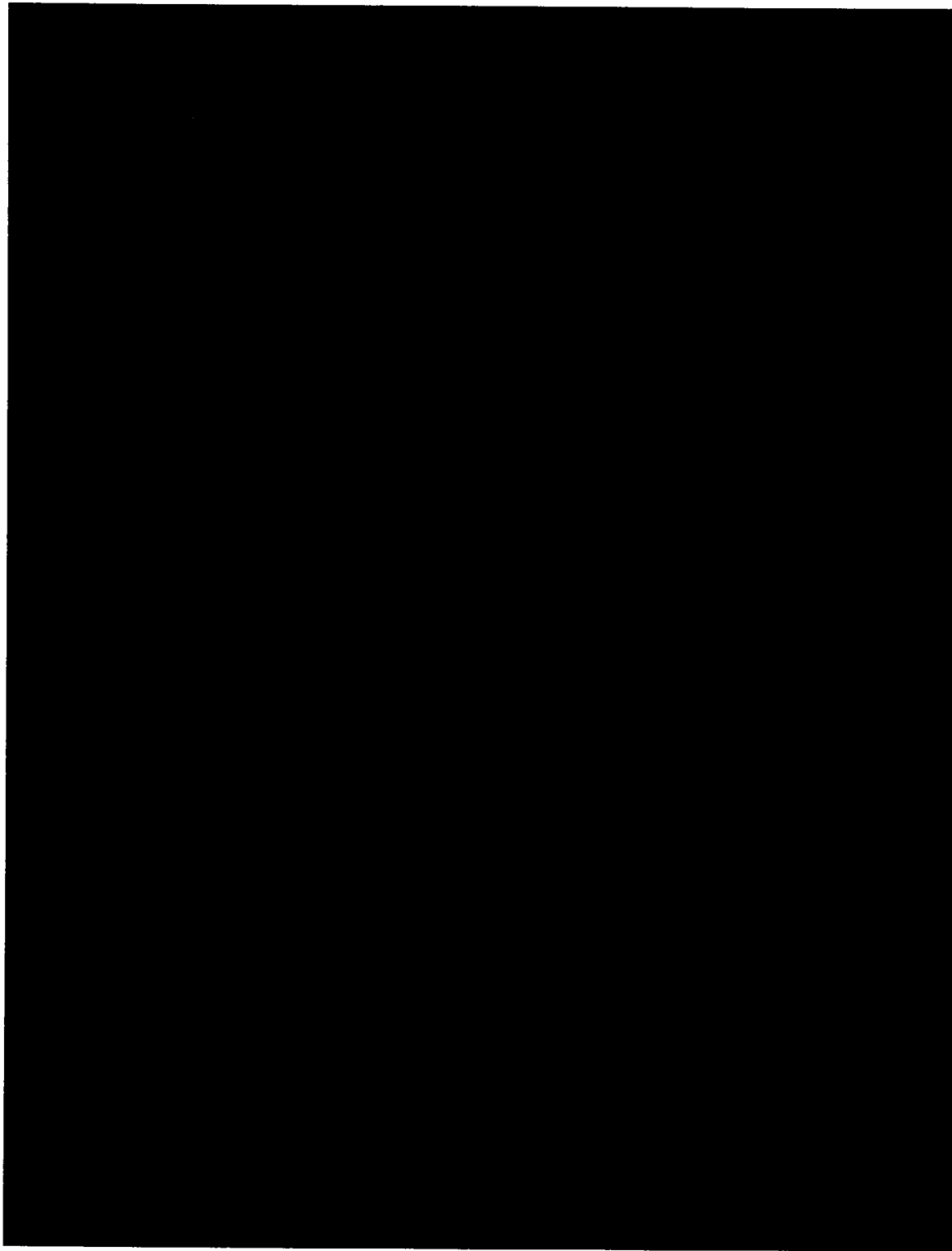


Figure 9

A legend to Figure 9 is attached as Appendix 1.

Figure 10 provides an overview of much, but not all, of the investment that EMI Music is making globally to support the new digital business model. From 2002 through 2006, EMI Music's global IT group has invested approximately [REDACTED] in capital expenditures. This includes roughly [REDACTED] in information technology expenditures for U.S. operations alone. EMI Music's global operational expenditures [REDACTED] are [REDACTED] for 2002 through 2006. Even assuming that 2006 expenditures remain constant, with no inflation, by 2011 EMI Music will have invested [REDACTED] on a new digital business model.



**Figure 10**

These significant investments in a new digital infrastructure demonstrate why the transition to digital delivery is hardly a windfall for the record companies. EMI Music is already

strained from these pressures. If the mechanical rate becomes prohibitive, it will reduce the amount of product that EMI Music NA can take to market, because products that are marginally profitable under current conditions will cease to be profitable with an increased mechanical royalty.

This is exactly what has happened with ringtones. Figure 11 is an illustrative example of the current economic model in place for an average physical, download, and ringtone products, using average costs from EMI Music NA's 2005 profit and loss statement. EMI's typical wholesale price for a physical CD is [REDACTED] with a mechanical royalty rate of [REDACTED] of the net sales price. Using EMI Music NA's 2005 costs as a percentage of revenue, the revenue generated from the sale of a typical CD is [REDACTED]. An increase in the mechanical rate would further deteriorate the profitability of the physical model. Based on EMI Music NA's average costs from 2005, the typical download for EMI has a mechanical rate of [REDACTED] and, because of savings in manufacturing and distribution, results in a [REDACTED]. (Again, this model does not fully include the costs of investments in the new digital infrastructure).

The typical model for ringtones, however, is completely different. The costs associated with ringtones are similar to those associated with downloads, with the exception being that the current mechanical royalty rate demanded by music publishers is at least [REDACTED] of wholesale for ringtones. That [REDACTED] in the mechanical royalty rate, however, is sufficient to convert the marginally profitable model for downloads into a completely unprofitable model for ringtones.

In fact, EMI Music NA has been forced to curtail its releases of ringtones due to low profitability caused by, among other things, the excessive rate demanded by music publishers.

For example, EMI Music NA currently has over [REDACTED] tracks from its current catalog available for digital download. By contrast, only [REDACTED] tracks are currently available for purchase as ringtones, which is only [REDACTED] of total catalog available for digital download.

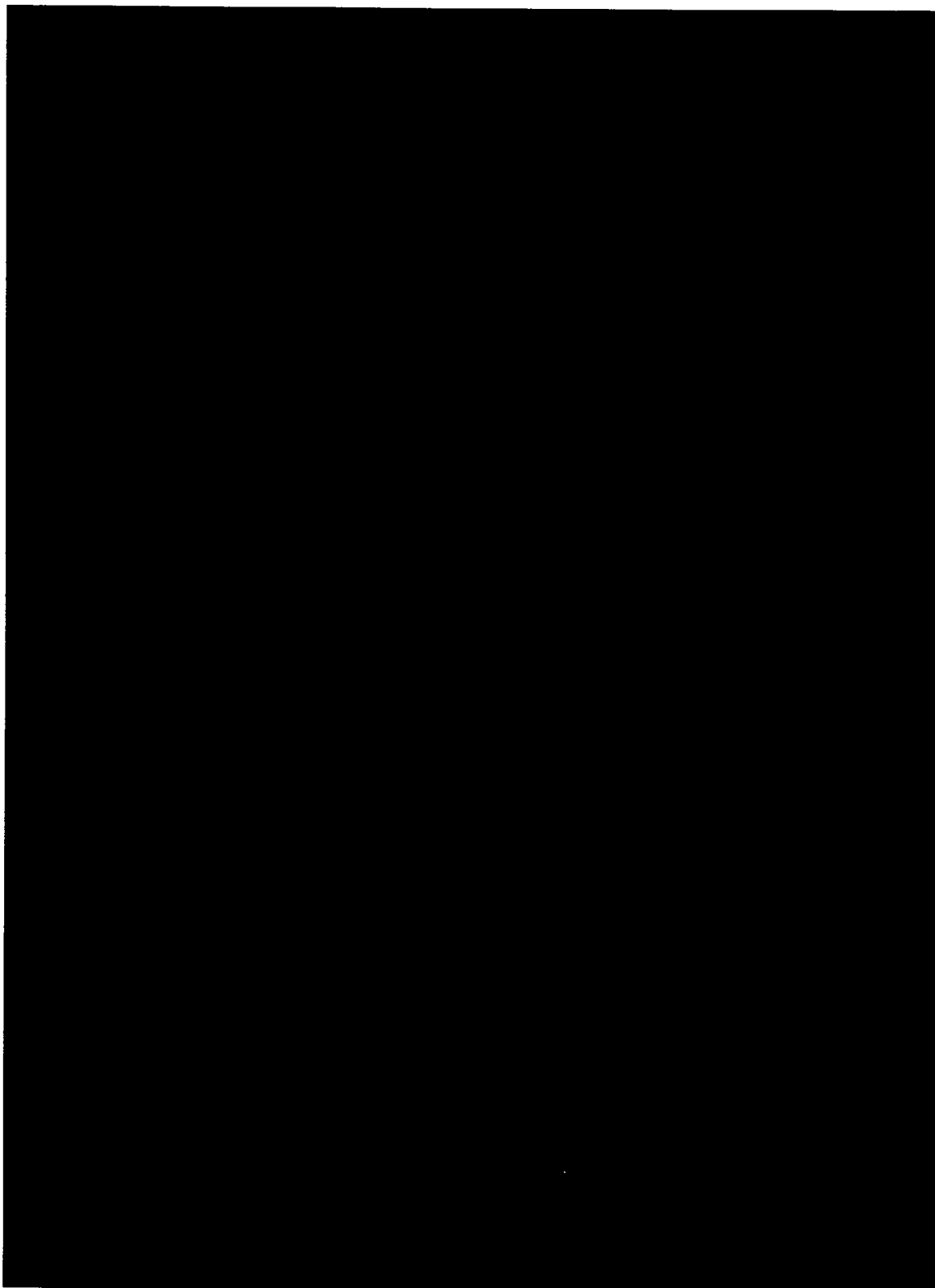


Figure 11



## **II. THE CURRENT MECHANICAL ROYALTY RATE AND STRUCTURE ARE OUTDATED AND UNWORKABLE IN THE CURRENT ENVIRONMENT**

Changes in the music industry make the current penny rate mechanical license unworkable and impede a record company's ability to effectively adjust to changes in the marketplace. Record companies currently bear a disproportionate amount of the risk in dealing with changed circumstances, and participation by the parties is not aligned. Moreover, the current rate becomes more cost prohibitive as a product ages and diminishes the record company's ability to fully exploit a product through its entire life cycle. A percentage based mechanical royalty would rectify these problems and provide the flexibility needed by record companies to quickly adjust to changes in the marketplace.

### **A. Record Companies Bear More Risk than Music Publishers**

The fundamental economic difference between music publishers and record labels lies with the allocation of risk. Record labels have a much higher risk profile than music publishers. Record labels bear the lion's share of the risks associated with the endeavor by absorbing enormous upfront costs in return for a low hit rate of success. There is a high cost of entry in the record business, with a large commitment of resources beyond the simple investment in advances. For example, record labels bear all of the costs in A&R, including discovering and developing talent, recording and production. In 2005 alone, EMI Music NA invested [REDACTED] [REDACTED]. Labels provide tour support and bear all of the marketing costs, including costs of promotion, publicity, advertising, retailer co-op advertising, and consumer marketing in print, Web, and television. In 2005, EMI Music NA spent just under [REDACTED] in third party costs to support the marketing and promotion of its albums. In addition, EMI Music NA spent [REDACTED] [REDACTED] on internal marketing and promotional overhead to promote its albums. Labels also

invest in and maintain the product supply chain, which not only includes the costs of manufacturing and distribution for physical products, but enormous investments to support and develop a digital supply chain that can not only distribute audio content, but also the metadata, art and video associated with it. As I explained in Section I.D above, by 2011 EMI Music will have invested almost [REDACTED] dollars globally to develop this new digital supply chain.

Notwithstanding these heavy investments, most albums in this business fail. I have evaluated EMI Music NA's rate of success for new releases from our front-line labels for the past 2 years. During that time, [REDACTED] out of every [REDACTED] new releases was a commercial failure. That is, for [REDACTED] of [REDACTED] albums, the net sales revenue generated from the release was insufficient to cover [REDACTED]

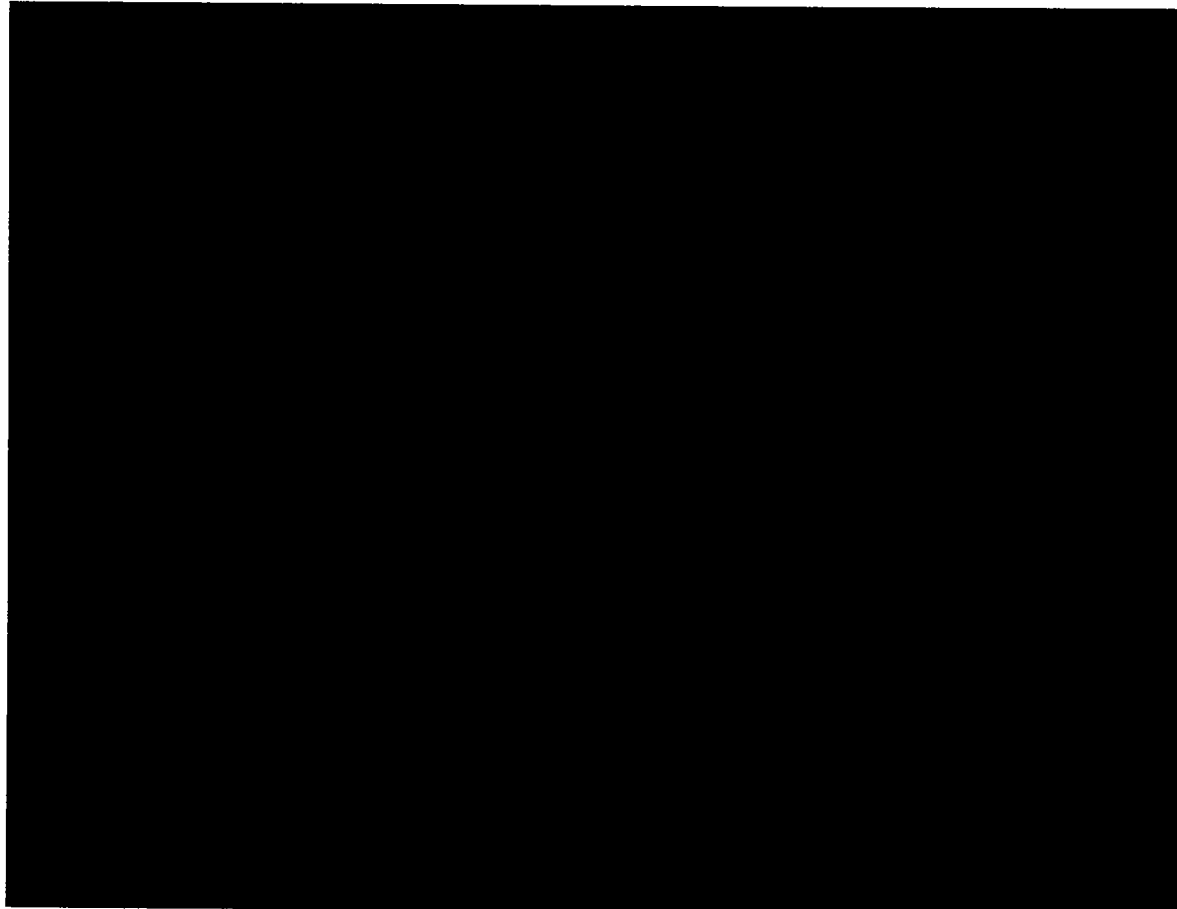
[REDACTED] The irony of the current system is that music publishers always benefit from these enormous investments but share virtually none of the risk for the [REDACTED] of albums that fail. Even for projects that result in enormous losses, the publisher's profit margins remain constant.

For example, Figure 12 demonstrates varying rates of return for music publishers and EMI Music NA when looking at costs associated with creating an album and the revenue generated from sales of the album. Because of the current penny per track royalty rate, as Figure 12 shows, the publishers' rate of return for one of EMI Music NA's successful albums, [Album A], was [REDACTED] (where EMI Music NA had a return of [REDACTED]), which was roughly the same as

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3

the rate of return of one of EMI Music NA's commercial failures [Album B] at [REDACTED] (where EMI had a return of [REDACTED]). The publishers' rate of return has no relationship to the underlying success of the album. On an average basis for 2005, EMI Music NA had an average rate of return of [REDACTED] of net sales while music publishers had an average rate of return of [REDACTED] of net sales.



**Figure 12**

Of course, the rate of return on a developing artist can be even worse for a record company than the example of [Album B] cited above. More often than not, record companies do not recoup the marketing and promotional expenditures, artist advances, and other costs associated with a new album by a developing artist. And even high sales are no guarantee of success. It is a common misconception that high album sales necessarily mean that a record

company makes a healthy profit on an album. That often isn't the case. A gold album could still be unprofitable because of the enormous investments in marketing and promoting the album may not be recouped by the sales generated. And where marketing and promotion or foreign royalties are extremely high, even a triple platinum album can generate extremely low rates of return on net sales for a record company. In each of these instances, however, publishers are guaranteed a positive rate of return off of net sales as soon as the first album is sold.

As these examples demonstrate, the risk allocation between music publishers and record labels is misaligned. Record labels bear almost all of the risk, but do not realize a commensurate return on that risk from sales revenue in the vast majority of cases, even where an album may result in high sales. The publishers' rate of return on net sales, however, is inconsistent with the underlying success or failure of the album. It is, in fact, the constant investment by record companies that results in this steady, predictable income stream for music publishers.

**B. Music Publishers Bear Little or No Cost to Support a Product Through Its Entire Life Cycle**

Just as publishers do not equitably share in the risks for artists that are commercial failures, they do not equitably share in the risks of an album through its entire life cycle. All products and artists have a life cycle, with different price points in the market and different margins of return for record companies. Frequently, in order to introduce a new artist to the marketplace EMI prices a new album at a "developing artist" price point, which is significantly lower than standard new release pricing.

While some top catalog releases are consistently profitable, it is necessary for record companies to continually re-invest in the catalog in different ways. After the initial release of an album, record companies must continually re-invest in the album during its entire life cycle. Record companies incur the costs of providing product to retailers with increasingly long

payment cycles, returns on the product, and bad debt resulting from retailers who cannot keep their commitments. Record companies often have to invest in repackaging and re-mastering an album to keep it fresh and then in marketing those versions.

The price point of many products, however, must be reduced from full price to a “mid price” price point as they get older. This downward pressure on the price of some albums as they age means that there is less and less available return with each additional investment by the record company.

In addition, record labels must often re-invest in their catalog, while for music publishers the record label catalog functions as an annuity. Publishers make no new investments, yet maintain consistent, unchanging rate of return throughout the entire life cycle of the product. For many mid price products, the statutory rate is so prohibitive that we have no choice but to apply for a reduction in the mechanical to be paid.

Figure 13 provides an illustrative example of how the profit and loss economic model of a product changes during its life cycle. These sales prices in Figure 13 are EMI Music NA’s typical sales prices for a developing, standard product, and mid price product. As Figure 13 shows, the mechanical royalty cost takes a larger percentage of net sales as the product grows older, with the publishers making their highest margins of [REDACTED] when the product is at its lowest price point and the margin based on net sales for the record company is at its lowest.

In addition, depending on the nature of the release, the mechanical royalties owed under the current statutory rate can be significantly higher. For example, catalog releases typically require high track counts to be competitive, but the current penny per track mechanical royalty significantly increases the costs of these types of releases.

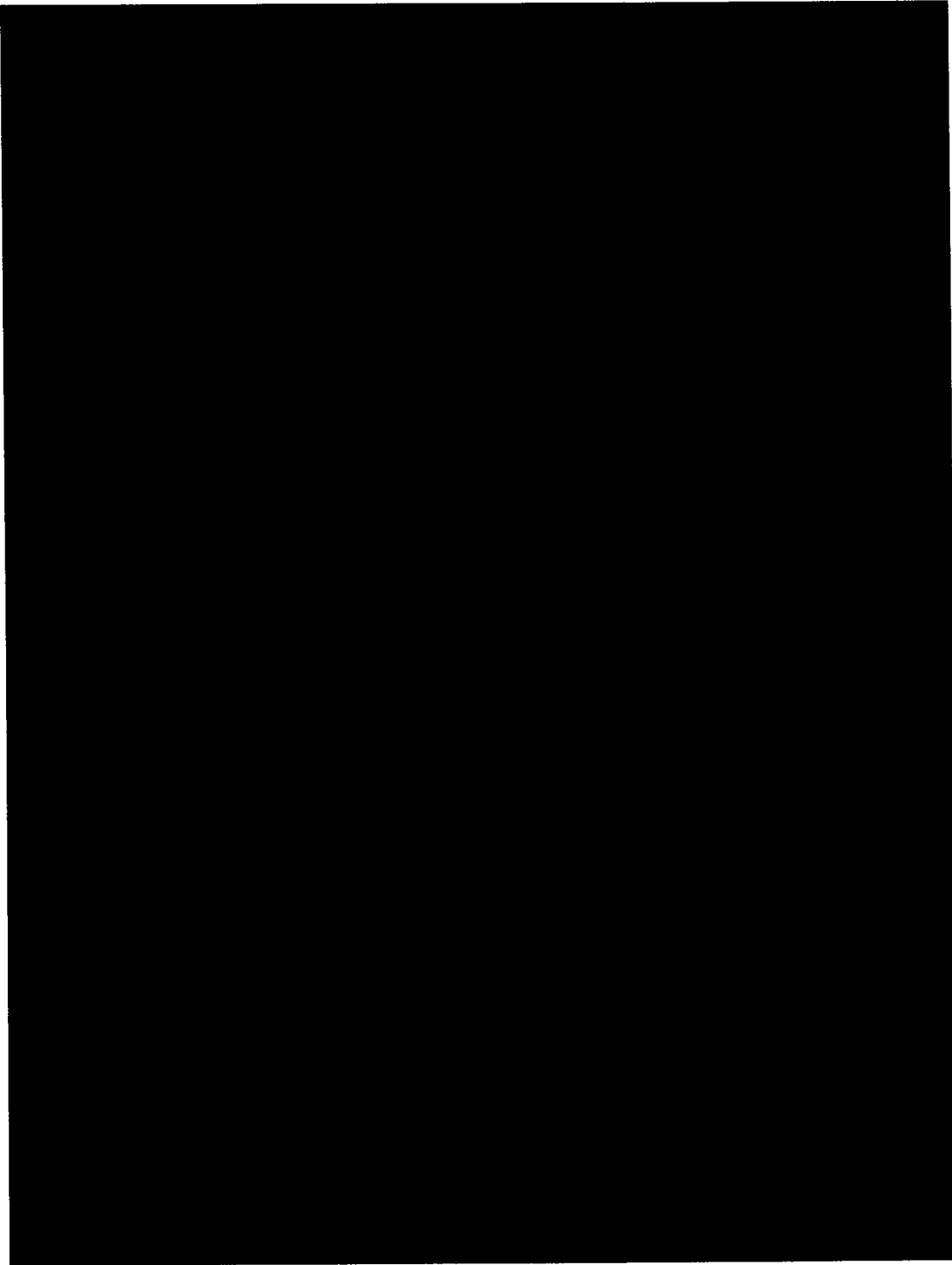


Figure 13

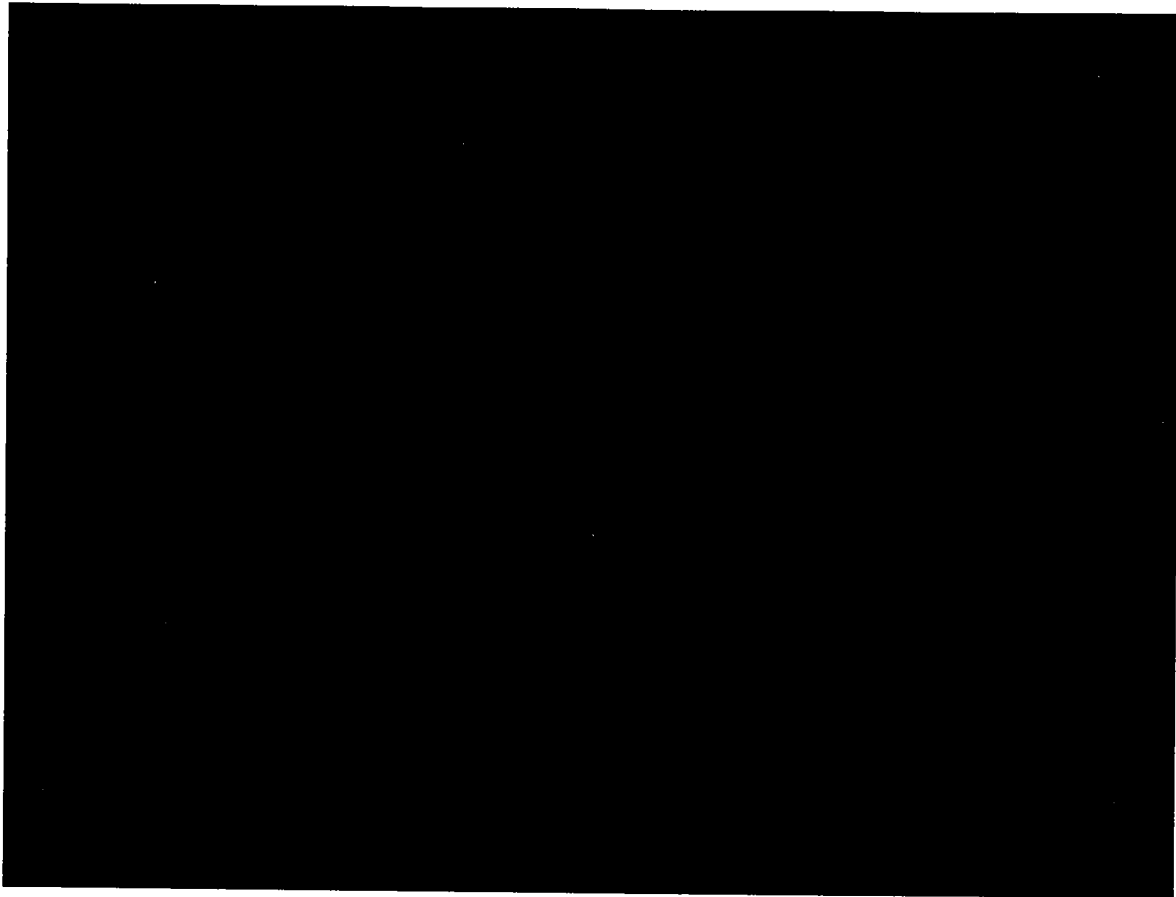
**C. Participation on a Per Track Basis Does Not Match the Economic Reality of the Current Marketplace**

The current penny rate per track mechanical royalty does not mirror the market reality that there is increasing competition in the marketplace. As discussed above, there is enormous price pressure from both consumers and retail partners that effectively restrains what EMI Music NA can charge and even forces price decreases. Increasing the track count on an album, therefore, does not enable record companies to charge more for the product. Moreover, there are ever-increasing sources of competition in the form of digital pressures and piracy, which plays a similar role in depressing album prices.

The current penny rate per track royalty in conjunction with downward price pressures can be prohibitive, and projects have to be significantly scaled back if we are unable to obtain rate reductions where the cost of publishing is so high. As with new releases, this is especially true on catalog projects and compilations when we attempt to enhance the consumer offering. In addition to downward price pressure, the market expects greater value these days and, as a result, catalog projects and compilations are starting to require higher track counts along with special packaging, video offerings, and exclusive tracks to distinguish themselves and get the attention of retailers. Because of the current penny per track royalty, however, a high track count dramatically increases the cost of releasing a compilation and would make some projects economically unfeasible. For those releases, EMI Music NA must either forgo the project or expend additional resources to try and negotiate a reduced mechanical rate for each track on the release, for which publishers typically require the payment of an advance. (Once again, the publishers' return is guaranteed, when the record company takes most of the risk). EMI Music NA currently has [ ] employees dedicated solely to resolving licensing issues for compilations and catalog re-releases.

Because of retailer and consumer price pressure, in most cases, the wholesale price of an EMI CD will stay the same regardless of the number of tracks on the album, and albums with 14 tracks are sold at the same wholesale price as albums with 16 tracks. Yet the underlying mechanical royalty cost is substantially higher for the 16 track album because of the current penny rate per track royalty. Figure 14 gives an illustrative example. For a 14 track album (which is the industry average for 2006), the mechanical royalty cost under the current rate would be \$1.27 or [REDACTED] of the wholesale price of a typical EMI album. For a 16 track album, however, the rate increases to \$1.46 or [REDACTED] of the wholesale price. Although a higher track count may help drive sales of an album and benefit all the parties involved, the publishers receive a premium that no other participant receives and that does not generate any additional revenue on a per album basis. Moreover, the penny per track royalty insulates music publishers from any downward price pressure.





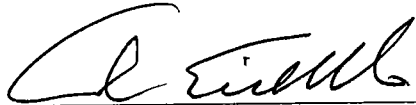
**Figure 14**

**CONCLUSION**

The recording industry is a much riskier business than the music publishing industry. There have been fundamental changes in the marketplace in recent years that have increased those risks and are caused by a declining physical market, unprecedented retail pressures, and a transition to a digital supply chain that requires massive investment by record companies. Publishers are currently insulated from the pricing pressures experienced by record companies in this changing marketplace and not longer share equitably in the risks of the business. Despite the increased risk borne by record companies, music publishers disproportionately benefit from the investments that record companies make in artists and sound recordings. Publishers' percentage share of sales revenues remains relatively constant across record company releases and product

life cycles, even when those releases are commercial failures. The result is that the current royalty rate no longer matches the economic reality of the current marketplace. A change from the current fixed cents rate mechanical royalty to a percentage based royalty is needed to relieve the growing pressure on the recording industry and to spread the risks of the music business more equitably.

I declare, under penalty of perjury, that the foregoing testimony is true and correct  
to the best of my knowledge.

  
Colin Finkelstein

Date: Nov 29 2006

APPENDIX 1

